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Empirical Insights into Corporate Contractarian Theory

Abstract – In UK and US company law and corporate governance, a highly influential economic theory views the company, and the rules related thereto, as a nexus of contracts for organising business activity. This so-called contractarian theory of the company depicts fundamental corporate governance arrangements as a form of private ordering, in which rules are spontaneously produced in the absence of formal legal intervention. This article draws upon broader empirical evidence of real world private ordering to make two essential arguments, which provide much-needed nuance to the idealised view of spontaneous governance found in the contractarian analysis. First, it emphasises the significance of a distinctive and essential correlative and causal connection between hierarchy and the development and nature of private orders. Second, it highlights the ways in which the state positively interacts with the purported self-regulatory capability of the market to produce these uneven endogenous rules.

A. INTRODUCTION

The importance of whether conventional legal approaches or private governance arrangements are the optimal rule-making strategy to regulate the complexity of corporate activity has led to much ink being spilled over the pages of legal monographs and textbooks, law review articles, and policy documents.¹ This intense debate about apparently distinct but inter-related aspects of comparative institutional competence reached its apex during the neo-liberal revolution of the 1970s, primarily in the US, but also a decade later when British accents joined the chorus. A pivotal step in this turning point was the invocation of neo-classical economic theory in legal literature, which, in essence, brought law and economics into the path of company and securities law. The academic and practitioner narrative on both sides of the Atlantic Ocean, in turn, has coalesced increasingly around an economic paradigm

¹ This has been a central question in welfare economics since Adam Smith's famous argument that the market would lead to the optimal allocation of resources to their highest and most efficient use. See A. Smith, *An Inquiry into the Nature and Causes of Wealth of Nations* (Clarendon Press, 1976 edn, R. H. Campbell and A. S. Skinner (eds)). For an overview of the debates on private ordering and legal centrism, see general: 'Symposium: Law, Economics and Norms' (1996) 144 *University of Pennsylvania Law Review* 1643-2399.

that regards the company, and the rules related thereto, as no more than an explicit and implicit set of “private” contractual arrangements between shareholders, directors, employees, creditors, suppliers, etc. This deregulatory, individualistic depiction of company law and corporate governance is referred to as the so-called “contractarian” or “nexus of contracts” theory.² It seeks to explain the legal governance structure of the company, and company law more generally, as the endogenous outcome of a collection of autonomous and rational actors freely negotiating notional bargains to produce and enforce rules that regulate their exchange activities. According to this logic, these market-based interactions generate a spontaneous order (rather than legal order established by authority) to govern fundamental aspects of organisational activity, which results from the individual participants naturally selecting and evaluating the optimal mixture of efficient rules and norms that create, modify, and transfer resources. The law and economics brand of contractarianism has breathed new life into the shareholder primacy principle in UK and US company law and governance. This pro-shareholder agenda typically denotes the corporate managerial standard of generating an optimal (or at least relatively high) dividend or capital return from a company’s business for the exclusive benefit of its equity holders.³ In particular, a contractarian analysis of the company, and company law generally, normally emphasises the constitutional primacy of shareholders over corresponding demands, and an entitlement to surplus profits based on ideals of free contracting and efficient institutional evolution.

It would be erroneous to suggest that this article seeks to undermine the entirety of contractarian theory, or that it presents a universal challenge to the sources and contours of law and economics. Nonetheless, it does sound a note of objection to two fundamental

² There are too many works written in this genre to cite exhaustively. For the foundational literature, see below, n 27.

³ C. Mayer, ‘Corporate Governance, Competition and Performance’ (1997) 24 *Journal of Law and Society* 152 at 155.

‘artificial and counter-factual’⁴ assumptions made by contractarian scholars when seeking to characterise fundamental features of corporate governance and company law in private contractual terms. First, the article questions the idealised and therefore artificial basis upon which notions of individual rationality and uninhibited agreement are said to produce spontaneous governance, not least because this depiction of rule making ignores the role of hierarchy within these notional bargaining activities. It submits, instead, that a causal and correlative relationship often exists between socio-economic hierarchy and the development of private orders. This stratified governance structure incentivises power holders – such as, shareholders in a corporate setting – to err in favour of privately generated rules to maintain the beneficial power arrangement. This uneven distribution of power incentivises or disciplines lower-ranking corporate participants, who are co-opted into this structure in such a way that they are prevented from dissenting, to interact with others, even when the norms and decisions might be unfavourable to the interests of those weaker participants. Second, the article challenges neo-classical economic claims about de-centralised rulemaking, and submits that private orders do not necessarily emerge without overall design or operate at the margins of more traditional legal or regulatory structures. Rather, it is important to understand the frequent interaction between law and markets, and the notion that non-legal systems typically displace in part, *yet rest upon*, the extant legal regime. This view highlights how formal legal and political institutions are in general a vital pre-requisite for privately generated rule making, and that state interventionism normally constructs the conditions necessary for private orders in all sorts of cooperative interactions. The integration of this dual form of power – through socio-economic pressure that stems from intragroup hierarchies, and the pervasive influence of the state in the structural emergence and

⁴ M. Moore, *Corporate Governance in the Shadow of the State* (Hart, 2013) at 247, observing that the theory has ‘no innate empirical content but – rather – begins life as nothing more than a theoretical “empty vessel” that requires subsequent “filling” by scholars on an artificial and counter-factual basis’.

functioning of private markets – produces a twin reality of domination that privileges financial capital within the notional company.

In order to make the arguments above, the article goes beyond orthodox company law discussion to examine in more detail the reality of neo-classical economic claims about spontaneous governance, and the role of the state, when seeking to explain prevailing corporate rules and institutions in private contractual terms. This is achieved through a critical re-reading of two broader ethnographic case studies that purport to identify situations in which a wide range of human activity endogenously provides itself with informal law and order without state intervention. The cases that form the basis of our empirical enquiry are the Diamond Dealers Club of New York,⁵ and rancher/farmer relations in Northern California.⁶ These real-world examples of mercantile activity and notional arbitration agreements are in general considered prototypes of private ordering in the wider literature.⁷ However, an analysis of the two case studies illustrates in particular how the implicit or explicit cooperation and free bargaining within these intergroup relationships normally emerges and functions in the context of hierarchical structures and state interventionist strategies.⁸ It is important at this juncture to note, also, that the same structures and state

⁵ L. Bernstein, 'Opting Out of a Legal System: Extralegal Contractual Relations in the Diamond Industry' (1992) 21 *Journal of Legal Studies* 115.

⁶ R. C. Ellickson, *Order Without Law: How Neighbours Settle Disputes* (Harvard University Press, 1991).

⁷ There is a range of other relevant cases that are not discussed in detail because of space constraints. See generally, B. Richman, 'Ethnic Networks, Extralegal Certainty, and Globalisation: Peering into the Diamond Industry' in V. Gessner (ed.), *Legal Certainty Beyond the State: Empirical Studies and Theories of Change* (Hart, 2009) at 31; L. Bernstein, 'Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions' (2001) 99 *Michigan Law Review* 1724; M. Gomez, 'The Tower of David: Social Order in a Vertical Community' (2014) 10 *Florida International University Law Review* 215.

⁸ A number of historical cases have been used to suggest that private communities have both the incentive and the means of spontaneously evolving their own well-functioning law and order in the absence of any recognisable state involvement. However, many of these examples appear to be taken primarily from stateless or nearly stateless social orders, and this contributes very little to understandings of "legitimate" private ordering within modern nation states in which an official, functioning legal system of some sort exists. Further, there a number of naïve and factually incorrect assumptions that serve to undermine some of the overall claims made. Accordingly, a discussion of pre-nation state or illegitimate private orders is beyond the scope of this article. For some representative examples from the literature, see e.g. B. L. Benson, 'The Spontaneous Evolution of Commercial Law' (1989) 55 *Southern Economics Journal* 644; T. L. Anderson and P. J. Hill, 'An

interventionist strategies, which contribute to the emergence and functioning of private orders in close-knit communities, can emerge in a myriad of surprisingly impersonal or broad settings where parties do not repeatedly interact, such as high finance and business.⁹ Above all else, the insights and understandings that arise from these two case studies serve to essentially undermine a number of romanticised or subjective claims made by contractarian scholars about the institutional status quo in company law being endogenously produced through notions of individual rationality and internal agreement. Up to this point, empirical or contextual evidence has rarely featured in the law and economics analysis of organisational activity.¹⁰ Indeed, despite significant and sustained treatment for several decades or more, the corporate contractarian analysis remains squarely situated within a *theoretical* framework. Against this backdrop, it is submitted that too much intellectual effort in the contractarian tradition has been devoted to subjective description and explicitly normative writing, and that not enough has gone into discovering and understanding more about the physical or concrete experience of how private systems of rules work to regulate relationships among the groups that adopt them.

A simple point, which has arguably taken on more urgency in light of the aforementioned criticisms about corporate legal writing, is well made by David Feldman, who wrote in 1989 that ‘scholarship is related to the good of knowledge. The object is to discover more about

American Experiment in Anarcho-Capitalism: The Not so Wild, Wild West’ (1979) 3(1) Journal of Libertarian Studies 9; Leeson, *ibid* at 143-144; P. Leeson, ‘Better Off Stateless: Somalia Before and After Government Collapse’ (2007) 35(4) Journal of Comparative Economics 689.

⁹ For some representative examples from the extensive literature on this subject, see J. Armour and S. Deakin, ‘Norms in private insolvency: The “London Approach” to the resolution of financial distress’ (2001) 1 Journal of Corporate Law Studies 21; Bruce L. Benson, ‘Economic Freedom and the Evolution of Law’ (1998) 18 Cato Journal 209 at 218; H. Beale and T. Dugdale, ‘Contracts between businessmen: planning and the use of contractual remedies’ (1975) 2 British Journal of Law and Society 45S. Macaulay, ‘Non-Contractual relations in business’ (1963) 28 American Sociological Review 45.

¹⁰ J. Armour, ‘Publication Review: An Economic and Jurisprudential Genealogy of Corporate Law’ (2002) 61(2) Cambridge Law Journal 467 at 468.

whatever is being considered, and to understand is better.’¹¹ Following on from this it is apt to note that the insights of this article contribute to a broader school of developing progressive company law scholarship, which seeks to refashion traditional thought paradigms by questioning, challenging and attempting add nuance to contractarian analyses of *what* a company is and *why* it exists. The article makes a distinct and important contribution to this general line of argument by providing a fresh perspective and valuable insights for the practice and study of the design and/or operation of the corporate regulatory system. In doing so, it discredits neo-classical economic predictions of companies and finance as responses to hypothetical states of the world. On a more general level, meanwhile, the article will further undermine the conceptually and empirically tenuous association that is traditionally drawn by economic analysis between the goals and responsibilities of company law and the shareholder primacy principle. The rest of the article proceeds as follows. Part B provides an exposition of the contractarian theory of corporate governance arrangements, before Part C briefly illustrates the prevalence of the paradigm theory within the law itself, legal writing and general policy discussion. This is done in broad strokes only and to the extent necessary to delineate the two aforementioned functional falsities that lie at the heart of this influential theory. Part D then compares the article’s two over-arching claims to documented studies of private ordering, and this illustrative test suggests that the present argument is consistent with empirical examples in the private ordering literature. Part E offers some concluding remarks.

B. THE CONTRACTARIAN THEORY OF RULE CREATION

¹¹ D. Feldman, ‘The Nature of Legal Scholarship’ (1989) 52 Modern Law Review 498 at 498, observing that ‘[s]cholarship is related to the good of knowledge. The object is to discover more about whatever is being considered, and to understand is better.’

The British courts have frequently asserted that directors are empowered agents of the company, with which they are situated in a fiduciary relationship.¹² It is of course trite that, for over a century, companies have been regarded as having distinct juristic personality.¹³ In the fierce controversy over corporate personhood, however, one truism resounds through the literature: a company has ‘no soul to be damned and no body to be kicked.’¹⁴ This has generated problems of accountability of corporate boards in company law and academic writing. The practical response from UK company law and policy, and many other jurisdictions inheriting British law, has been to use the economic logic and language of “agency”¹⁵ to justify the position of shareholders as de facto principal and monitor of the executive office-holders’ discretionary administrative power.¹⁶ Indeed, the law deploys multiple instruments to regulate and contain this managerial agency problem. There are a number of important doctrinal rules that internalise the interests of shareholders within the boards’ managerial calculus. This is known variously as the so-called shareholder primacy or shareholder exclusivity principle.¹⁷ Broadly speaking, shareholders have ultimate and revocable constitutional prerogative to draft and amend the articles of association,¹⁸ and

¹² *Re City Fire Equitable Fire Insurance Co* [1925] Ch 407, 426.

¹³ *Salomon v A Salomon & Co Ltd* [1897] AC 22. Of course, one should bear in mind that the Lords’ unanimous ruling was simply giving effect to the doctrine of corporate personality as enshrined in section 6 of the Companies Act 1862.

¹⁴ The quote is attributed to Baron Edward Thurlow, an eighteenth-century British lawyer and politician. The quotation was given wide publicity by John Coffee Jr.’s influential article: ‘No Soul to Damn: No Body to Kick’: An Unscandalized Inquiry into the Problem of Corporate Punishment’ (1981) 79 *Michigan Law Review* 386.

¹⁵ The most influential paper in this movement was Michael Jensen and William Meckling, ‘Managerial behaviour, agency costs and ownership structure’ (1976) 3 *Journal of Financial Economics* 305.

¹⁶ Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (HUP 1991) at 38, 67-68; William Klein, ‘The Modern Business Organization: Bargaining Under Constraints’ (1982) 91 *Yale Law Journal* 1521 at 1538-1540.

¹⁷ The literature on shareholder primacy is too voluminous to cite in its entirety. Some useful examples include, Jonathan Macey, ‘An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties’ (1991) 21 *Stetson Law Review* 23; Bernard Black and Reinier Kraakman, ‘A Self-enforcing Model of Corporate Law’ (1996) 109 *Harvard Law Review* 1911; D. Gordon Smith, ‘The Shareholder Primacy Norm’ (1998) 23 *Journal of Corporation Law* 277. On two very different interpretations of shareholder primacy, one based around shareholder protection and the other centred on shareholder empowerment, see Lyman Johnson and David Millon, ‘Misreading the Williams Act’ (1989) 87 *Michigan Law Review* 1862 at 1899-1907.

¹⁸ Sections 21 and 33 of the Companies Act 2006.

collective ex ante appointment¹⁹ and removal rights²⁰ that they are entitled to exercise over the board of directors. Additionally, directors are now obliged under section 172 of the Companies Act 2006 merely to “have regard to”, amongst other factors, the interests of the environment *while seeking to promote the success of the company for the benefit of its shareholders*.²¹ Shareholders also have the limited right to remedy managerial misfeasance or malfeasance on an ex post facto basis in court,²² as well as the no frustration prohibition in the UK Takeover Code.²³ The story of UK company law in the twentieth century and early twenty-first century is thus one of a narrow depiction of the internal decision-making structures of business organisations, whereby corporate officers and managers are in the ordinary course of business formally accountable to shareholders alone.

The main driver of this relatively narrow focus of company law and practice, which we might trace back to the neoliberal revolution of the 1970s,²⁴ has been the aforementioned invocation of neo-classical economic analysis in US and UK corporate legal scholarship and policy-making. It was a discipline-shaping theoretical turn that effectively brought law and economics into the path of company and financial markets law. At the heart of this doctrinal and normative analysis is a “contractarian” model of the company, and the rules related

¹⁹ Art. 20 of Model Articles for Public Companies.

²⁰ Section 168 of the Companies Act 2006.

²¹ Following extensive debate about this provision, the academic or practitioner consensus narrative suggests that it encapsulates a shareholder primacy approach, while the (unenforceable) social or public element of the duty is essentially ameliorative. On this, see. e.g. Christopher Bruner, *Corporate Governance in the Common Law World* (CUP 2013) at 32-33; Moore, above n 4 at 28 and 192-194; Daniel Attenborough, ‘The Neoliberal (Il)legitimacy of the Duty of Loyalty’ (2014) 65(4) Northern Ireland Legal Quarterly 405 esp. at 418-427.

²² ss260-264 of the Companies Act 2006.

²³ General Principle 3 and Rule 21 of the UK’s Takeover Code prevent the types of unilateral action that a listed company’s board of directors may take when subject to an actual or imminent unsolicited takeover bid. On this no frustration prohibition see e.g. David Kershaw, ‘The Illusion of Importance: Reconsidering the UK’s Takeover Defence Prohibition’ (2007) 56(2) International and Comparative Law Quarterly 267.

²⁴ For some useful works on neoliberalism, see Raymond Plant, *The Neoliberal State* (OUP 2010); David Harvey, *A Brief History of Neoliberalism* (OUP 2007); Noam Chomsky, *Profit Over People: Neoliberalism and Global Order* (Seven Stories Press 1998).

thereto,²⁵ which has resonated with the traditional legal virtues of conservatism and classical liberalism. While there were nascent contractarian views of company law and its institutions that were identifiable in a strand of legal scholarship during the late-nineteenth century,²⁶ the modern brand of the theory was pioneered over several decades ago by the influential contributions of financial economists and company lawyers.²⁷ In the fewest possible words, the theory frames the fundamental rules and structures of company law and corporate governance in “private” enabling or default terms,²⁸ which implies that company law is essentially a derivative of contract law.²⁹ The institutional competence of “legal positivist” ideas of law as mandated by the state or the courts are highly circumscribed due to the purportedly rent seeking, inefficient and restrictive effects on business.³⁰ In place of such regulatory instruments, neo-classical economics, and especially its new institutional branch, idealises the self-regulatory capability of the market to endogenously produce and enforce rules to govern corporate activities.³¹ The “market” in this context refers to an uninhibited process of private bargaining between a collection of autonomous and rational individuals

²⁵ There are too many works in this genre to cite exhaustively. For an overview, see e.g. Michael Whincop, ‘Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law’ (1999) 19 *Oxford Journal of Legal Studies* 19 at 28; Stephen Bainbridge, ‘Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship’ (1997) 82 *Cornell Law Review* 856 at 856.

²⁶ M. Horwitz, ‘Santa Clara Revisited: The Development of Corporate Theory’ (1985) 88 *West Virginia Law Review* 173 esp. at 184-185; M. Horwitz, *The Transformation of American Law 1870-1960: The Crisis of Legal Orthodoxy* (OUP, 1992), at 75, 94. For a fascinating discussion of a purportedly more demonstrable formulation of the theory in 1934 fascist Germany, see E. McGaughey, ‘Ideals of the Corporation and the Nexus of Contracts’ (2015) 78(6) *Modern Law Review* 1057 at 1066-1068.

²⁷ See generally, Armen Alchian and Harold Demsetz, ‘Production, Information Costs and Economic Organizations’ (1972) 62 *American Economic Review* 777; Jensen and Meckling, above n 15; Eugene Fama, ‘Agency Problems and the Theory of the Firm’ (1980) 88 *Journal of Political Economics* 228; Frank Easterbrook and Daniel Fischel, ‘The Corporate Contract’ (1989) 89 *Columbia Law Review* 1416; and Easterbrook and Fischel, above n 16.

²⁸ On the categorisation of legal rules, see Melvin Eisenberg, ‘The Structure of Corporation Law’ (1989) 89 *Columbia Law Review* 1461.

²⁹ Easterbrook and Fischel, above n 16 at 166. On the counter-intuitive claim that company law may be trivial, see Bernard Black, ‘Is Corporate Law Trivial? A Political and Economic Analysis’ (1990) 84 *Northernwestern University Law Review* 542; Roberta Romano, ‘Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws’ (1989) 89 *Columbia Law Review* 1599.

³⁰ On the limits of conventional law and regulation, see Dan Awrey, William Blair and David Kershaw, ‘Between Law and Markets: Is There a Role For Culture and Ethics in Financial Regulation?’ (2013) 38 *Delaware Journal of Corporation Law* 191 at 198-205.

³¹ The classic accounts of Hayek’s distinction between constructed legal rules and de-centralised law are: Friedrich Hayek, *Law, Legislation and Liberty* (Routledge 1973) esp. at 72-91; Friedrich Hayek, *The Road to Serfdom* (Routledge 1944) esp. at 75-90.

adapting themselves to circumstances, and it is this efficient cooperation and conflict that determines the substantive content of company law rules.³² When the presence of constitutive legal rules and structures is irrefutable, contractarian theory usually infuses formal law with a ‘passive-instrumental’³³ quality, whereby mandatory legal rules are viewed as “standard-form terms” *that would otherwise tend to evolve* were the costs of making adequate provision for all possible contingencies sufficiently low.³⁴

Based on the logic above, contractarian thinking disaggregates the existence of the company as a distinct legal institution into a market-directed bundle of contracts,³⁵ either express or implied,³⁶ and these notional bargains consist of many different kinds of risks and opportunities that are voluntarily exchanged amongst rational and self-interested participants.³⁷ Accordingly, every corporate actor is said to contribute enterprise-specific inputs (for example, equity, human capital, credit loan, custom) in exchange for receiving material benefits for themselves (such as, dividend, interest, price, wage). This logic has opened the way for a divisive reinvention of the shareholder’s primary or exclusive status within company law and corporate governance. From a contractual perspective, non-equity interests are theoretically able to bargain in advance, or re-negotiate along the way, for more specific rights and obligations in respect to their investments, whether in terms of a fixed

³² This is a process of “bottom up” rule making that Hayek, Schumpeter, and other lesser-known members of the “Austrian School” of economics refer to as giving rise to a “spontaneous order”. The classic accounts of Hayek’s distinction between constructed legal rules and de-centralised law are: F. A. Hayek, *Law, Legislation and Liberty* (Routledge, 1973) esp. at 72-91; F. A. Hayek, *The Road to Serfdom* (Routledge, 1944) esp. at 75-90.

³³ Moore, above n 4 at 73. For a similar US perspective, see e.g. Robert Thompson, ‘Corporate Law Criteria: Law’s Relation to Private Ordering’ (2005) 2(1) *Berkeley Business Law Journal* 97 at 98.

³⁴ Easterbrook and Fischel, above n 27 at 1428. See also, Richard Posner and Andrew Rosenfeld, ‘Impossibility and Related Doctrines in Contract Law: An Economic Analysis’ (1977) 6 *Journal of Legal Studies* 83.

³⁵ This is based on the view that debates about the personification of the corporate entity are preoccupied with abstract concepts rather than practical or concrete issues. On this, see e.g. William Bratton, ‘The New Economic Theory of the Firm: Critical Perspectives from History’ (1989) 41 *Stanford Law Review* 1471 esp. at 1493.

³⁶ Easterbrook and Fischel, above n 27 at 1428-1429.

³⁷ Daniel Fischel, ‘The Corporate Governance Movement’ (1982) 35(6) *Vanderbilt Law Review* 1259 at 1273. For a general critique of economic rationality and its implications for the analysis of law, see Neil Duxbury, *Patterns of American Jurisprudence* (Clarendon Press 1997) at 364-381; Wanda Wiegers, ‘Economic Analysis of Law and “Private Ordering”: A Feminist Critique’ (1992) 42 *University of Toronto Law Journal* 170.

wage or interest rate, and so on. The shareholder, rather, ranks behind the satisfaction of all rights that other parties have contracted for in advance because she is unable to bargain *ex ante* for a specified return from corporate activity.³⁸ These equity investors have the “residual” claim in the sense that if the business risk causes the company to lose money, it comes from her profits; if it leads the company to make additional profit, all of it belongs to her.³⁹ This lower priority, risk bearing, and costs associated with encouraging maximum corporate performance, in theory at least, mean that shareholders are collectively incentivised to demand *additional* legal protection and/or governance rights within the company to compensate for any disadvantage.⁴⁰ The various other essentially autonomous and rationally self-interested corporate constituents are implicitly prepared to concede structural protection and governance rights because of a pre-established harmony between shareholder wealth and the long-term quantitative benefits for the company.⁴¹

It follows that a typical feature of the system in which the heterogeneous market actors of the company recurrently interact with one another is that of an implied or sometimes explicit

³⁸ See Easterbrook and Fischel, above n 27 at 1425. On complete and incomplete contracting generally, see Simon Deakin and Alan Hughes, ‘Economic Efficiency and the Proceduralisation of Company Law’ [1999] *Company Financial and Insolvency Law Review* 169 at 177.

³⁹ Easterbrook and Fischel, *ibid.* For criticism of the thesis that shareholders constitute residual claimants, see Lynn Stout, ‘Bad and Not-so-Bad Arguments for Shareholder Primacy’ (2002) 75 *S Cal L Rev* 1189 at 1193-1195. It is also worth noting that the changing ownership patterns of UK and US large publically traded companies over recent decades might call into question whether shareholders can be viewed as residual risk bearers, because the dominant players in financial markets are increasingly large institutional investors (such as financial institutions or sovereign wealth funds) whose clients might be said to be the ultimate risk bearers. See e.g. Office for National Statistics, ‘Statistical Bulletin: Ownership of UK Quoted Shares 2014’ (2 September 2015) available at <www.ons.gov.uk/economy/investmentspensionsandtrusts/bulletins/ownershipofukquotedshares/2015-09-02> [last accessed on 25 March 2016].

⁴⁰ Easterbrook and Fischel, above n 16 at 91.

⁴¹ A point made famous by Milton Friedman ‘The Social Responsibility of Business is to Increase its Profits’ (1970) *The New York Times Magazine*. Cf. D. Millon ‘Communitarians, Contractarians, and the Crisis in Corporate Law’ (1993) 50(4) *Washington and Lee Law Review* 1373 at 1378, pointing out that, ‘[t]his view assumes that feasible... contracting strategies exist for correction of the harmful external effects of shareholder/management activity and, perhaps, that such effects are relatively uncommon.’ It is also worth noting that the environment is not privy to this notional bargaining process, which means that it has traditionally been viewed as an extra-contractual externality for which environmental regulation, rather than company law, represents the only available means of protection. On this point, see D. Attenborough, ‘An Estoppel Based Approach to Enforcing Corporate Environmental Responsibilities’ (2016) 28(2) *Journal of Environmental Law* pp tbc.

acknowledgement of hierarchy according to relative status or authority at the point of bargaining.⁴² It is through this ranking process that the ‘complex, on-going, and unpredictable’⁴³ enterprise-specific inputs and outputs can be brought into alignment so as to yield a particular organisational result.⁴⁴ Although the level of specificity and emphasis varies from one voice to the next, there is little dissimilarity between neo-classical and especially institutional economics about this essential point. In some sense, then, the recognitional capacity of contractarianism concedes that participants within the company are not necessarily equal. In order to overcome this conceptual limitation, the theory makes an evaluative prediction, which imbues corporate participants with autonomy, economic rationality, and the imperative to self-maximisation. This enables decision-makers to “freely” bargain for a proportionate and satisfactory share of the organisational rent through a strategic process of conflict and cooperation with one another. However, the assumed capacity of a collection of corporate participants to endogenously coordinate themselves to fairly produce and enforce rules regulating their activities, paradoxically, fails to give adequate treatment to a less prominent question. This enquiry relates to whether such rules and norms are universally inclusive of the structurally differentiated objectives and preferences of the suppliers, employees, creditors, and so on, associated with companies. Financial economists and company lawyers typically soften these questions about the significance of hierarchy and how it might interact with the character of the private order, its scope, and its components. Instead, these commentators elect to reduce the multifaceted issue of hierarchy down to an artificially simplified game theoretic study of decision-making

⁴² The classic example of this approach is R. H. Coase, ‘The Nature of the Firm’ (1937) 4 *Economica* 386.

⁴³ L. A. Stout and M. M. Blair, ‘A Team Production Theory of Corporate Law’ (1999) 85(2) *Virginia Law Review* 247 at 278.

⁴⁴ Jensen and Meckling, above n 15 at 307.

between the various enterprise-specific relations.⁴⁵ So this move achieves at a corporate conceptual level what neoliberal rationality does at a more general level, namely, erases an entire analytics of socio-economic power, subordination, and inequality from political understanding and from the law based upon it.⁴⁶

Overall, it is fair to suggest that the contractarian theory has permeated the theoretical discourse⁴⁷ in US corporate legal scholarship,⁴⁸ and inevitably influenced the academic writings of a number of UK and other Commonwealth company law textbooks⁴⁹ and law review articles.⁵⁰ Simultaneously, the theoretical discourse is the manifestation of a form of politics and it organises the political space, often with the intention of monopolising it. To this end, it has found favour in various significant policy-making discussions that go to the

⁴⁵ This observation chimes with Robert Solow's prescription for doing good economics, in which he asserts that '[t]he very complexity of real life... [is what] makes simple [economic] models so necessary.' See R. Solow, 'A Native Informant Speaks' (2001) 8(1) *Journal of Economic Methodology* 111 at 111.

⁴⁶ There literature on this subject is too extensive to cite. In brief, Adam Smith's view is that inequality of bargaining power stems from unequal possession of property. See Smith, above n 1 esp. at section 8, section 12. Karl Marx considered this to be part of the ephemeral bourgeois ideology thrown up by any systems of private property ownership. See e.g. K. Marx, *Wage Labour and Capital* (H. E. Lothrop (tr), New York Labor News Company, 1902 edn). Thus, Smith and Marx, or indeed John Stuart Mill, would have had similar diagnosis, but drawn very different conclusions about what to do about it. Various progressive critiques of company law exist, and argue in general that this legal domain and its institutions are a major site of injustice in society. See e.g. J. Parkinson, *Corporate Power and Responsibility* (Clarendon Press, 1995). Adolf Berle came to opine that corporate regulation could contribute to a more "rationalized" system of wealth distribution by establishing a charter of social and economic rights (in effect, nullifying the effects of unequal property and bargaining power). See 'Property, Production and Revolution' (1965) 65 *Columbia Law Review* 1.

⁴⁷ Whincop, above n 25 at 28, asserting that 'contractarian theory is *inevitable* because of the contractual qualities of corporations [emphasis added].'

⁴⁸ S. M. Bainbridge, 'Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship' (1997) 82 *Cornell Law Review* 856 at 856, observing that contractarianism has 'mounted a largely hostile takeover of the corporate legal academy'.

⁴⁹ It would be a crude oversimplification to suggest that these textbooks have uniformly and unreservedly endorsed a contractarian approach in UK company law and corporate governance. However, the following examples include recognition as a historical-legal fact that the company can be viewed in contractual terms. See e.g. P. Davies and S. Worthington, *Gower & Davies Principles of Modern Company Law* (Sweet and Maxwell, 9th edn, 2012); D. Kershaw, *Company Law in Context: Text and materials* (OUP, 2nd edn, 2012). More explicit willingness to adopt a contractarian analysis can be found in R. Kraakman, et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP, 2nd edn, 2009); B. R. Cheffins, *Company Law: Theory, Structure and Operation* (OUP, 1997).

⁵⁰ Whincop, above n 25 at 28, asserting that 'contractarian theory is *inevitable* because of the contractual qualities of corporations [emphasis added].' Further support for this observation include, R. Grantham, 'The Doctrinal Basis of the Rights of Company Shareholders' [1998] *Cambridge Law Journal* 554 at 578-579; J. E. Parkinson, 'The Contractual Theory of the Company and the Protection of Non-Shareholder Interests' in D. Feldman and F. Meisel (eds), *Corporate and Commercial Law: Modern Developments* (Lloyd's of London Press, 1996) 121 at 121.

heart of UK company law and practice.⁵¹ Moreover, the rules of company law itself comprise many different elements that appear to give credence to a private contractual view of the company. Most notably, the company's articles of association contain primarily internal governance rules providing for its constitutional structure and distribution of power between the board and the shareholder body. The rules set out in the corporate constitution are contractual terms upon which the shareholders agree to become associated with the company.⁵² Perhaps unsurprisingly UK law views the legal status of the constitution in contractual terms,⁵³ and this conclusion resonates with a number of judicial pronouncements that 'acknowledge contract as *the* animating force within company law.'⁵⁴ Against this backdrop, the theoretical paradigm that is generally posited by commentators attempting to understand company law from a private contractual perspective remains hugely significant in providing the discipline's vantage point for understanding and assessing that law.

C. CONTRACTARIANISM'S FUNCTIONAL FALSITIES

Despite the apparent ubiquity of contractarian theory, it is not without its opponents, and many of which have expressed serious misgivings about a number of clear limitations and internal inconsistencies that have become apparent in recent years.⁵⁵ On the one hand, it is

⁵¹ Law Commission Consultation Paper, *Corporate Directors* (1997 LCCP No.153); Department of Trade and Industry (now the Department for Business, Innovation & Skills), *Modern Company Law for a Competitive Economy: The Strategic Framework* (London: DTI 1999) at para. 2.4.

⁵² s 33 of the Companies Act 2006.

⁵³ See e.g. *Hickman v Kent Romney Marsh Sheep-Breeders Association* [1915] 1 Ch 881. On this, see David Kershaw, *Company Law in Context: Text and materials* (OUP 2nd edn. 2012) at 79-87.

⁵⁴ See e.g. *Fulham Football Club (1987) Ltd v Richards & Anor* [2011] EWCA Civ 855. On 22 February 2012 the Supreme Court refused permission to appeal the decision. On this point, see the excellent analysis in H. McVea, 'Section 994 of the Companies Act 2006 and the Primacy of Contract' (2012) 75(6) *Modern Law Review* 1123. Cf. the recent UK Supreme Court decisions in *Prest v Petrodel Resources Ltd and others* [2013] UKSC 34 and *VTB Capital plc v Nutritek International Corporation and others* [2013] UKSC 5, which endorse the *Salomon* principle, above n 13.

⁵⁵ The classic critiques are Paddy Ireland, 'Property and contract in contemporary corporate theory' (2003) 23(3) *Legal Studies* 453; William Bratton, 'The "Nexus-of Contracts" Corporation: A Critical Appraisal' (1989) 74 *Cornell Law Review* 407. See also, B. R. Cheffins, 'The Trajectory of (Corporate Law) Scholarship' (2004) 63(2) *Cambridge Law Journal* 456 at 485-487 (and accompanying footnotes), discussing the writings that

clear that contractarian theory does not provide a complete account of the company, and the rules related thereto, whether the inquiry limits itself to legal discourse or is posed at a more general level. On the other hand, these criticisms have been made within the private-prudential ideological climate of company law, which has traditionally been at best indifferent and at worst entirely hostile to even relatively moderate proposals for change in the way we think about law.⁵⁶ Nonetheless, it is important to shed light on the deficiencies of the dominant contractarian paradigm because a generally accepted theory that attempts to understand the functions performed by company law provides the discipline's presumed vantage point for describing and evaluating contemporary governance rules. But if that intellectual framework is misguided, then accounts of the formation and application of those rules, and the contemporary vantage point of both scholar and law maker, finds itself in the wrong place. Accordingly, this section exposes to view two further important presuppositions or assumptions underlying contractarian thought that have hitherto received insufficient attention. These are the partial and therefore inaccurate depictions of hierarchy and market actor autonomy, and the theory's rigid dichotomy between the capacity of markets to self-regulate and more traditional legal institutions and rule making.

First of all, it will be recalled that private conceptions of company law in general recognise a somewhat modest existence of hierarchy within the notional company. However, its significance as a component of private rule producing approaches is reduced and simplified within a more general political ideology embedded in autonomy and the promotion of individual freedom of choice. It is submitted that this is an impoverished understanding of hierarchy, which elides the reality that all but the most powerful corporate actors often lack

have used the contractarian theory as a point of departure so as to develop a more fully rounded conception of company law.

⁵⁶ M. Moore, 'Bridging the Gap Between Labour Law and Company Law' (2015) 44(3) *Industrial Law Journal* 425 at 425.

the actual or economic freedom to choose an agreement or the terms of that bargain, even though they might be *legally free* to strike whatever contract they choose.⁵⁷ In practice, this uneven political-economic structure means that the weaker subjects of the company, and the rules related thereto, can rarely choose, dissent, or exit from it. It is therefore more accurate to acknowledge the latent and illegitimate role of hierarchy based on wealth, influence, and power, which work to emphasise the relative primacy of equity holders within the notional company over countervailing demands. More importantly still, these political-economic configurations are in general a pre-existing and essential component of the formation and nature of spontaneous governance. This hierarchy enables dominant market actors, namely, the shareholders, to directly or indirectly influence weaker members to use the private system *even when the given allocations of entitlements are not in their interests to do so*. When power holders make access to resources or participation in the organisational setting contingent upon the use of private mechanisms of resource allocation created by them, the threat of losing access to these resources produces not only the “choice” to use these private forums, but also compliance with their decisions.⁵⁸ The acknowledgement that incentive structures are not unanimously agreed upon between corporate actors, but are apportioned based on standing in the hierarchy, improves our ability to explain which controller-selecting and substantive norms the group adopts. When a private order develops, power holders in the group tend to rely on it to maintain their power by preserving and manufacturing norms that deepen and embed intragroup hierarchy, thus guaranteeing both the private order and their own continued control over that ordering process.

⁵⁷ M. R. Cohen, ‘The Basis of Contract’ (1933) 46(4) Harvard Law Review 553 at 568, remarking that ‘[a]s the result of the various forces that have thus supported the cult of contractualism there has been developed in all modern European countries (and in those which derive from them) a tendency to include within the categories of contract transactions in which there is no negotiation, bargain, or genuinely voluntary agreement.’

⁵⁸ G. M. Hodgson, ‘On the Institutional Foundations of Law: The Insufficiency of Custom and Private Ordering’ (2009) 43(1) Journal of Economic Issues 143 at 157, noting that ‘[t]he [Stanley] Milgram experiments provide... some striking empirical material. Species existing in social groups for millions of years evolve dispositions to obey those in apparent authority. In specific cultural settings, we learn to recognise individuals in social positions with authority over others.’ See also, N. Chomsky, ‘Community Activists’ in P. R. Mitchell and J. Schoeffel (eds), *Understanding Power: The Indispensable Chomsky* (Vintage, 2003) at 196-198.

A second oversimplification from the contractarian theory is the depiction of private ordering as ‘a profound example of free markets’,⁵⁹ whose norms ‘are not manufactured or enforced by the state’⁶⁰ in which an official legal system of some sort exists. The normative effect is to view the appropriate role of public regulation as merely correcting any structural failure in the endogenous rule making, by authoritatively producing market-mimicking principles on either a mandatory or at least default basis. It is through this lens that law and economics tends in general to impute a passive-instrumental role to state interventionist approaches when it comes to the regulation of the governance of the company.⁶¹ However, legal realism and critical legal studies,⁶² amongst other schools of social-scientific enquiry,⁶³ have demonstrated convincingly that most, if not all, law is “public” in the sense that it is conditional upon the state. The proposition therefore that ‘markets are legal, political (and, therefore, regulatory) products, not spontaneously arising, pre-regulatory, pre-legal and pre-political phenomena’⁶⁴ would today scarcely be viewed outside of contractarian thinking as a new or exciting truth. In this regard, it is submitted that the *actual* role of the state is qualitatively different to the traditional functionally reflexive one embedded in the

⁵⁹ O. Yadlin, ‘A Public Choice Approach to Private Ordering: Rent-Seeking at the World’s First Futures Exchange’ (2000) 98 Michigan Law Review 2620 at 2625.

⁶⁰ Ibid at 2620.

⁶¹ Moore, above n 4 at 73.

⁶² See e.g. V. Nourse and G. Shaffer, ‘Varieties of New Legal Realism: Can a New World Order Prompt a New Legal Theory?’ (2009) 95 Cornell Law Review 61; H. Erlanger, B. Garth, J. Larson, E. Mertz, V. Nourse, and D. Wilkins, ‘Is it Time for a New Legal Realism?’ (2005) Wisconsin Law Review 335. The observation that all law is essentially a constituent element of public interests, power, and democracy, might lead to the normative extension of the state’s acceptable political authority in company law and corporate governance. For arguments that run along these lines, see D. Oliver, *Common Values and the Public-Private Divide* (CUP, 1999) at chapter 11; E. Fox-Decent, *Sovereignty’s Promise: The State as Fiduciary* (OUP, 2011) at Part I. For an excellent overview of the public/private distinction in law, see also the published symposium: (1982) 130(6) University of Pennsylvania Law Review 1331-1588.

⁶³ P. Leeson, ‘Anarchy Unbound: how much order can spontaneous order create?’ in P. J. Boettke, *Handbook on Contemporary Austrian Economics* (Edward Elgar, 2010) at 136, noting that, ‘[a]ccording to conventional wisdom, spontaneous order may be able to create some limited order in the “shadow of the state.” But it cannot create enough order to make the state unnecessary. Spontaneous order may flourish within the government-created meta-rules of social order. But it cannot create such meta-rules itself.’

⁶⁴ P. Ireland, ‘Law and the Neoliberal Vision: Financial Property, Pension Privatisation and the Ownership Society’ (2011) 62(1) Northern Ireland Legal Quarterly 1 at 29. See also, D. Campbell, ‘Review Article: The End of Posnerian Law and Economics’ (2010) 73 Modern Law Review 305 at 326.

contractarian psyche. In view of the inherent shareholder centricity of modern UK company law, state interventionist strategies, often in the form of de-centralised, networked forms of regulation,⁶⁵ purposefully establish and preserve through positive action an artificial institutional framework appropriate to the efficient profit-making practices of private ordering.⁶⁶ The degrees of intervention across traditional regulatory approaches range from acknowledging the existence of private orders, strategic omissions that lead to their emergence, or imposing them on aspects of a society that may be reluctant to participate in transactional and collective relations in an extra legal manner. Overall, the upshot is that constitutive legal rules are a necessary precondition and engineer of the development and nature of spontaneous governance.

D. THE EMPIRICS OF BROADER PRIVATE ORDERING

The following examples serve to emphasise the distinctive and essential correlative and causal relationship between hierarchy and private ordering in merchant communities, whilst simultaneously drawing attention to the fact that the formation and nature of the private order is inextricably conditional upon positive state interventionist approaches. While this specific ethnographic research on private ordering typically documents these two parallel strands, the literature ignores their significance, and so this section provides a more textured account of spontaneous governance in each of the case studies, and a more compelling explanation of that ordering process. This presents an opportunity to relate innovative and reliable studies of *actual* private ordering practices to contractarian theories of the regulation of the governance of the company. Despite the enduring promise of the empirical legal movement, few legal

⁶⁵ S. Picciotto, 'Constitutionalizing Multilevel Governance?' (2008) 6(3) *International Journal of Constitutional Law* 457.

⁶⁶ Harvey, above n 24 at 2; B. Amable, 'Morals and Politics in the Ideology of Neoliberalism' (2011) *Socio-Economic Review* 3 at 10.

academics and practitioners publish meaningful empirical studies in law reviews, the primary forum for legal academic discourse.⁶⁷ This is despite the general view that many important standards in company law are based on assumptions about how the world works.⁶⁸ A central argument of this article therefore is that it is crucial for company lawyers and scholars, as good inter-disciplinary social scientists, to seek to add an empirical element to their positive and theoretical understandings of legal phenomena. Similarly, the corporate legal academy must be willing to change course if experience and evolution in the commercial world suggest that modifications in prior understandings are warranted. Empirically driven, positive doctrinal analysis is in general most enriching for two reasons. First, this type of analysis has a dramatic impact when it calls into question the descriptive accuracy of clear, well established “black letter law” or consensus theoretical understanding about that law.⁶⁹ Second, even when the primary use of empirical data is to describe doctrine or the effect of doctrine on behaviour, there is also an additional goal of using descriptive conclusions to support one or more normative claims about the way the law ought to be.⁷⁰ These insights, in turn, may be used to inform legal policy, law making, and legal theory about the design and/or operation of the corporate regulatory system.

1. The New York Diamond Dealers Club

Writing in the early 1990s, Lisa Bernstein’s pioneering study of ultra-orthodox Jewish

⁶⁷ On this observation about company law, see Armour, above n 10 at 468. On the absence of empirical analysis in legal scholarship more generally, see M. Heise, ‘The Importance of Being Empirical’ (1999) 26 *Pepperdine Law Review* 807 at 834; D. L. Rhode, ‘Legal Scholarship’ (2002) 115 *Harvard Law Review* 1327 at 1357-58. Cf. T. S. Ulen, ‘A Nobel Prize in Legal Science: Theory, Empirical Work, and the Scientific Method in the Study of Law’ (2002) 4 *University of Illinois Law Review* 875.

⁶⁸ L. E. Strine, ‘The Inescapably Empirical Foundation of the Common Law of Corporations’ (2002) 27 *Delaware Journal of Corporation Law* 499 at 499.

⁶⁹ R. Korobkin, ‘Empirical Scholarship in Contract Law: Possibilities and Pitfalls’ (2002) 4 *University of Illinois Law Review* 1033 at 1044-45.

⁷⁰ *Ibid* at 1048.

merchants who dominate New York's enigmatic diamond industry⁷¹ examines a community that is purported to systematically enforce commercial agreements through private order institutions and extra-legal sanctions in ways that are intended to make the public legal system largely extraneous to their interactions. Since the foundation of the Diamond Dealers Club in the early 1930s, Jewish merchants who overwhelmingly comprise the diamond industry have developed an elaborate, internal arrangement of rules, complete with distinctive institutions and disciplinary techniques, to resolve disputes and controversies among industry members and others. Consistent with the model, the industry's arrival at private ordering is explained by the transactional hazards of enforcing diamond credit sales, the particular importance of high-powered market incentives, and the relatively low costs of entry barriers. With approximately 2000 members, the club has grown into the largest diamond trade organisation in the US, and one of the leading diamond exchanges in the world. In an industry where important economic advantage depends largely on a dealer's network of contacts, membership gives a merchant presence and prestige, disseminates accurate and reliable information about other dealers' reputations, and access to a steady supply of precious stones. As a condition of membership, a dealer must sign an agreement to voluntarily submit to all disputes arising from the diamond business between herself and another member to the club's arbitration system. The agreement to arbitrate is binding. The club's procedural rules clearly reflect the industry's preference for the voluntary resolution of disputes. The bylaws are structured to give the parties control over the dispute resolution process and to create financial incentives to settle. Unless the club's private arbitration panel opts not to hear the case,⁷² the member may not seek judicial redress of her grievance. If she does so, she will be fined or expelled from the club.

⁷¹ Bernstein, above n 5 at 115.

⁷² Ibid at 126-127, noting that this can happen for a number of reasons, but particularly when a claim has been conciliated, mediated, arbitrated or litigated outside of the club and/or parties have sought remedies elsewhere.

Any member of the club who has a claim arising out of or related to the diamond business against another member has the right to file a written complaint against the member who must then submit to the club's legally binding private adjudication. According to Bernstein, arbitration is more efficient than litigation because it is cheaper, industry relevant, and subjects the member to unique pressures to settle promptly.⁷³ More importantly still, provided judgments are complied with, the existence of the arbitration proceeding as well as its eventual outcome is officially kept undisclosed, which avoids social ostracism and reputational damage.⁷⁴ Given the well-established institutional premium on secrecy as well as the barriers to public enforcement, very few merchant disputes spill into New York's state courts.⁷⁵ Disputes are, instead, enforced exclusively through the Diamond Dealers Club's threat of private, extralegal sanctions. The club's board of arbitrators does not apply New York law of contract and damages; rather it resolves disputes on the basis of endogenous trade customs and usages. Many of these are set forth with particularity in the club's bylaws, and others simply are implicitly known and accepted. In general, the board of arbitrator's use suspension, rather than expulsion, as an informal default rule to secure compliance with its decisions.⁷⁶ Another enforcement mechanism sometimes invoked by the arbitrators is a proceeding in Jewish rabbinical courts against the party who refuses to comply with a judgment. Because these courts have the authority to ban an individual from participation in the Jewish community, this is a powerful threat against Orthodox members of the diamond industry.⁷⁷

⁷³ Ibid at 126.

⁷⁴ Ibid at 124.

⁷⁵ B. D. Richman, 'Community Enforcement of Informal Contracts: Jewish Diamond Merchants in New York' Harvard Law School John M. Olin Center for Law, Economics and Business Discussion Paper No. 384 (2002) at 15, available at <http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=1719&context=faculty_scholarship> [last accessed on 25 March 2016], noting that a party can appeal an arbitration board decision to New York state court only if there is a procedural irregularity. The board's substantive decisions are not reviewed. See *Rabinowitz v Olewski*, 100 A.D. 2d 539 (1984); see also *Goldfinger v Lisker*, 508 N.Y.S. 2d 159 (1986).

⁷⁶ Ibid at 129.

⁷⁷ Ibid at 130.

The club's private ordering processes have been interpreted as part of the unique commercial requirements of an industry, and not of New York's Jewish society in general. It is possible that the Jewish approach to private ordering has been particularly useful in the context of the diamond trade, but this is a very different claim from the standard argument that the club's mediation processes arose as an efficiency-oriented institution. Indeed, the existence of the Diamond Dealers Club is difficult to comprehend in isolation from New York's pre-existing Jewish community and its hierarchical institutions based on economic dependency.⁷⁸ When embedded in its broader context, it is submitted that the club is, in fact, the endogenous outcome of New York's Jewish community of the late 1920s and depends on that socio-cultural context for rules and norms.⁷⁹ To explain, the Russian pogroms of 1918 to 1921 resulted in large swathes of Jewish immigration to New York City. In response to this problem, two Jewish lawyers established the Jewish Court of Arbitration, which held its first session in early 1920. The passing of the New York Arbitration Act 1920, followed by the US Arbitration Act 1925 (now known as the Federal Arbitration Act), meant that agreements to arbitrate were valid and mediators' decisions given legally binding effect at common law.⁸⁰ The Jewish Court of Arbitration was replete with intergroup hierarchies in terms of both structure and substance, and this played a crucial role in the creation of private ordering within Jewish communities.⁸¹ In general, the court reinforced traditional or religious-based hierarchies as well as the Jewish laws and norms that supported the stratified social structure that had produced it in the first place. First, using a combination of positive and negative

⁷⁸ Richman, above n 75 at 17, observing that, 'nearly 85-90% of DDC members are Jewish' and '[s]ince Orthodox Jews tend to live in specific, insular communities, this means that familiar business relationships are also familiar community relationships, and the members' ties to each other do not end at the Club's door.'

⁷⁹ On the extent to which economic action is embedded in structures of social relations, see M. Granovetter, 'Economic Action and Social Structure' (1985) 91(3) *American Journal of Sociology* 481.

⁸⁰ English law equally states that any third party can be agreed by two sides to arbitrate in a commercial or domestic dispute.

⁸¹ Gomez, above n 7 at 228, noting that, interaction with endogenous rules 'is conditioned by the existence of an internal social hierarchy, which in turn [facilitates] compliance with the indigenous order.'

incentives, they produced a legal culture of avoiding public courts. Second, they served as enforcement mechanisms for the arbitral decisions of private forums. Third, they produced a clear, normative value ranking, without which effective informal sanctioning would not have been possible.

The Jewish court generally reinforced the traditional (religion-based) hierarchies as well as the Jewish laws and norms that supported the stratified social structure that had produced it in the first place. Further, there was a clear socio-economic gap between the court's mediators (rabbis, lawyers, judges, and distinguished laypeople) and the parties to the mediation (eastern European immigrants who lived in the impoverished Lower East Side neighborhood). These hierarchical differences were emphasised to engender confidence and implicit obedience.⁸² Simultaneously, affluent members of the community directed the immigrants' disputes to the Jewish court by using a set of positive and negative incentives. First, the Jewish court was free of charge and conducted in the immigrant's native Yiddish language. Second, one of the unwritten precepts was that, to help resolve the dispute, the affluent, influential judges promised financial, employment-related, or personal support to those claimants who agreed to use the court.⁸³ In other words, use of the court was incentivised by the promise that it would provide access to wealthy and influential members of the community. On the negative side, the court's arbitrators frequently persuaded litigants not to take their cases to public courts so as to avoid the dishonoring of the Jewish good name by dragging unseemly situations into a non-Jewish court.⁸⁴ Jewish claimants who opted to present a case before a public court were ostracised by the community, since such an action

⁸² Ibid at 229, remarking that, 'compliance with indigenous norms tends to be high basically because group members view them as legitimate, and this legitimacy extends to those in position of authority within the community.'

⁸³ I. Goldstein, *Jewish Justice and Conciliation: History of the Jewish Conciliation Board of American, 1930-1968 and a Review of Jewish Judicial Autonomy* (Ktav Publishing, 1981) at 92.

⁸⁴ Ibid at 89.

was regarded as undermining the authority of Jewish law and the rabbinical courts.⁸⁵ To understand the full implications of this social exclusion, the benefits of inclusion in the community require explanation. For example, membership in associations based on locality in the country of origin gave them sick benefits, compensation for loss of earnings for those sitting a ritualistic week-long mourning period after a death in the family, burial plots and funeral expenses, which were made available to paid-up members in good standing.⁸⁶ Thus, exclusion from the community and its associations impaired the immigrants' ability to survive in the new country.

The arbitration system of the Diamond Dealers Club equally depends on Jewish community institutions for enforcement. There are two ways in which these institutions enforce the club's decisions: one is through the rabbinical courts, and the other is through the use of coordinated informal sanctions. It is fair to suggest that most diamond merchants do not conduct business with a person who has been sanctioned for dishonest business activity, because 'their own reputation will suffer if they are known to transact with previous cheaters.'⁸⁷ On a formal level, the rabbinical courts can excommunicate a wrongdoer – a direct enforcement instrument that is rarely used – or the club arbitration committee can itself initiate a proceeding in a rabbinical court.⁸⁸ Less formal institutions also play a role in enforcing contractual compliance. There are numerous tangible, identifiable community goods, which have subtle hierarchies that dominate Orthodox Judaism. Relatively nuanced distinctions can translate into either valued privileges or disappointing slights, and the numerous religious goods offers community leaders an array of sanctions with varying degrees of severity. Community leaders can adjust these sanctions to correspond to the

⁸⁵ Ibid at 4.

⁸⁶ Ibid at 112.

⁸⁷ Richman, above n 75 at 29.

⁸⁸ B. D. Richman, 'How Community Institutions Create Economic Advantage: Jewish Diamond Merchants in New York' (2006) 31(2) Law and Social Inquiry 383 at 407.

severity of the offence caused, bringing about the desired deterrence without expending community resources.⁸⁹ For instance, ‘when the community is familiar with a member’s failure to comply with contractual obligations, religious leaders often withhold excludable community goods, such as participation in daily prayer, honors in life-cycle ceremonies, access to classes or teachers that are in limited supply, or enrollment in particularly select educational classes.’⁹⁰ Another important informal sanction relates to marriage. Arranged marriage is the norm in many ultra-Orthodox communities, and a family’s ability to find a good match for their offspring depends to a great extent on the family’s reputation. Failure to comply with private Jewish forums for dispute resolution compromises the family’s community status and, therefore, their offspring’s chances of an appropriate match.⁹¹ In merchant communities, a merchant’s dependence on her community’s resources drives her ultimate compliance with the industry’s norms and private rulings.⁹²

To summarise, the Diamond Dealers Club developed, and continues to exist, because the diamond merchants are not only a profit-oriented community, but also part of a larger community with its own legal culture. The club depends on that community for norms, enforcement, and population-screening mechanisms. The role and status of individuals within the cultural community are indistinguishable from their position in the trade community. The Diamond Dealers Club is part of a larger private-ordering mechanism that utilises class-based (Jewish Court of Arbitration) and religious (rabbinical courts) hierarchies to regulate itself. Economic dependency, along with the requisite inclusion in the community, produces trust, which in turn facilitates extralegal contracting. In addition, hierarchies are necessary to create a clear normative code, to induce people to avoid the

⁸⁹ Ibid at 408.

⁹⁰ Ibid at 407.

⁹¹ S. Heilman, *Defenders of the Faith-inside ultra-Orthodox Jewry* (Schocken Books, 1992) at 277-286.

⁹² B. D. Richman, ‘Firms, Courts, and Reputation Mechanisms: Towards a Positive Theory of Private Ordering’ (2004) 104 *Columbia Law Review* 2328 at 2345.

public order, and to enforce private settlements. As such, the club's system of dispute resolution cannot be viewed as an egalitarian enclave in a sea of hierarchy, distinguished from the culture that created it and enforces its decisions.

Turning to the role of the modern, functioning public order in the development of legitimate private orders within its jurisdiction, the first example of a qualitative restructuring of the state, involving not so much less regulatory intervention as a different kind of state intervention is that of the aforementioned New York state legislative reform project in the early 1920s. It will be recalled that this had the effect of explicitly recognising at common law the validity of private agreements to arbitrate. More importantly still, it can be seen as an artificial manipulation of the conditions necessary for a spontaneous order, where incentives are constructed 'to provide inducements that will make the individuals do the desirable things without anyone having to tell them what to do.'⁹³ This insight clearly reduces (although does not eliminate) the substance of previous claims that the emergence of private orders is attributable to the dysfunctional nature of the centralised law making.⁹⁴ Along similar lines, the Jewish Court of Arbitration was supported by public courts, which recognised its power by refusing to reverse decisions on appeal.⁹⁵ Indeed, 'the civil courts and the various social services agencies *recommended* the Jewish Court of Arbitration's services to those who *in their view would best be served by [it]* [emphasis added].'⁹⁶ It is unclear how vague the standard of "best served" was interpreted by the relevant authorities, but evidence suggests that the civil and criminal actions of low-status Jews were often referred to the hierarchical Jewish court on the basis of religious and/or ethnic grounds rather than the substance of the

⁹³ F. A. Hayek, 'The Use of Knowledge in Society' (1945) 35 American Economic Review 519 at 527.

⁹⁴ J. McMillan and C. Woodruff, 'Private Order Under Dysfunctional Public Order' (2000) 98 Michigan Law Review 2421 esp. at 2425.

⁹⁵ Goldstein, above n 83 at 48.

⁹⁶ Ibid at 99]. For a discussion of the various ways the law or state can ignore, strengthen, or undermine social norms, see R. Cooter, 'Normative Failure Theory of Law' (1997) 82 Cornell Law Review 947.

case.⁹⁷ Public officials were aware of the stratified context within which the Jewish court's adjudications took place. In a 1954 keynote speech to mark the 35th anniversary of the Jewish Conciliation Board of America (successor to the Jewish Court of Arbitration), then Supreme Court Justice, William Douglas, spoke about "The Problems of the Little People" with which the Jewish court admirably contended.⁹⁸ In sum, the type of private order developed is contingent not only on the flaws affecting the public order, but also on the positive attitude of the law toward the private order.⁹⁹

2. Rancher Relations in Shasta County, California

A second example of the role of hierarchies and the public order in the development of extra-legal orders is the case of Shasta County, California. Robert Ellickson's *Order without Law*¹⁰⁰ observed that Shasta County residents – contrary to the predictions of Ronald Coase's fêted 1960 article¹⁰¹ and much of the law and economics scholarship – ignore formal legal rules and engage in mutually advantageous cooperation by turning to adaptive norms to informally shape social behaviour and settle disputes.¹⁰² The parties in this community are owners of smaller "ranchettes", who are recently settled 'retirees or younger migrants from California's major urban areas',¹⁰³ and established cattlemen who own and operate large, intergenerational family ranches that may be worth more than a million dollars. These

⁹⁷ S. Buchler, "*Cohen Comes First*" and *Other Cases: Stories of Controversies before the New York Jewish Court of Arbitration* (Vanguard Press, 1933) at 79.

⁹⁸ Goldstein, above n 83 at 98.

⁹⁹ A. Porat, 'Enforcing Contracts in Dysfunctional Legal Systems: The Close Relationship Between Public and Private Orders: A Reply to McMillan and Woodruff' (2000) 98 *Michigan Law Review* 2459 at 2470, remarking that private ordering is often not strictly private, although it may well bear the marks of one.

¹⁰⁰ Ellickson, above n 6.

¹⁰¹ R. Coase, 'The Problem of Social Costs' (1960) 3 *Journal of Law and Economics* 1 esp. at 3-8, theorising that once legal entitlements are clearly defined, market actors in a transaction cost free world can bargain for a socially efficient outcome.

¹⁰² Ellickson, above n 6 at 4.

¹⁰³ *Ibid* at 20-21. Ellickson also notes that ranchette owners, whose properties are generally much smaller than those of cattlemen, 'may keep a farm animal or two as a hobby, but few of them make significant income from agriculture.'

cattlemen are further distinguished as traditionalists or modernists. Traditionalists tend to be less economically successful and allow their cattle to roam in unfenced mountain areas during the summer. Modernist cattlemen fence in their livestock, are economically more prosperous, tend to be younger than traditionalists, and more active in the Shasta County Cattlemen's Association.¹⁰⁴ Ellickson describes the relations of cattlemen and ranchette owners in the context of incidents involving stray cattle, which are owned by cattlemen but often trespass on the property of ranchette owners or on nearby highways, where cattle and drivers are often seriously injured or even killed in collisions. In his account, the way these incidents are addressed exposes an emergent order that is produced through exogenous foundational rules that exist without regard to the law. He describes these norms as 'non-hierarchical processes of coordination'¹⁰⁵ and argues that an idealised sphere of neighbourliness is shaped 'beyond the reach of the law.'¹⁰⁶

However, there are a number of difficulties with the path that Ellickson takes away from legal centralism, particularly in respect of the impoverished evidence to support the notions of individual consent and equality that are so central to his narrative of emergent order. Further, at some points in the book, he documents the effect that the law *does* seem have on informal order-producing processes, but leaves its significance hidden or half-articulated.¹⁰⁷ The problem is that Ellickson's model of human nature, like much of the literature in law and economics, is over-simplistic, depicting behavior as rational and self-interested in every context.¹⁰⁸ This undeveloped calculus seems strikingly incongruous to the actual grievances and disputes that permeate his over-arching account of voluntary cooperation in a purportedly

¹⁰⁴ Ibid at 22-25.

¹⁰⁵ Ibid at 5.

¹⁰⁶ Ibid at 4.

¹⁰⁷ Ibid at 116-119.

¹⁰⁸ B. Yngvesson, 'Beastly Neighbors: Continuing Relations in Cattle Country' (1993) 102 Yale Law Journal 1787 at 1790, suggesting that Ellickson's theory of motivation 'is still firmly in the economist camp; it can account only for a dispassionate process of calculated decision-making.'

close-knit cattle country. While these groups are geographically integrated, what Ellickson systematically fails to appreciate are the numerous embedded asymmetries between ‘a traditional agrarian order’ and ‘an emerging urban rival’.¹⁰⁹ The rivalry revolves around efforts to change the legal regime of Shasta County from open to closed range. Shasta County's residents believe that the liability of the owners of stray livestock for injurious events increases when a certain range is declared closed. Moreover, a closed range diminishes the cattlemen's ability to solve disputes privately, as it introduces a legal norm that can be enforced by law enforcement officials and the courts. An open range entails a very narrow interpretation of legal trespass as well as a broad interpretation of inevitable injurious events; it is thus associated with traditional norms, including private resolution of disputes that allow cattlemen to protect their interests regardless of the formal law.¹¹⁰

In terms of the capacity of these parties to exert influence over one another, cattlemen and ranchette owners significantly diverge, not only in the size and type of their material resources and in the depth of their knowledge of local ways,¹¹¹ but also in their symbolic status and the strength of their political connections to others in the county. Ranchette owners are relatively politically isolated because few of them have been in the area for long, and in recruiting cattlemen to their cause because even the modernists, who tend to fence in their cattle, tend to unite with traditionalists in opposing proposed legal changes that would lead to increased liability for owners of stray cattle.¹¹² Moreover, ranchette owners also lack the established ties to local officials that cattlemen have; officials have dealt with cattlemen regularly over the years and depend on them for positions as county supervisors, brand

¹⁰⁹ Ellickson, above n 6 at 117.

¹¹⁰ Ibid at 25.

¹¹¹ Ibid at 21 and 64, commenting that the shallow roots of ranchette owners in the area are reflected in cattlemen's perceptions that they are ‘not away of the natural working order’, while ranchette owners ‘admire both the cattlemen and the folkways traditionally associated with rural Shasta County.’

¹¹² Ibid at 25.

inspectors, or animal control officers. Finally, they are at a disadvantage because of a historical bias in Shasta and other northern county legislatures in favour of the traditional ranching method of running cattle at large.¹¹³ Because of the relative disempowerment of ranchette owners, the cattlemen's preferred choice of self-enforced norms prevails, which allows them to protect their interests and eschew the formal law. Their power enables them to intentionally avoid regulatory interference in this private dispute processing, even when it involves a violation of state law. The norm of private dispute management serves to reinforce Shasta County's social structure, where cattlemen are the ruling elite. In keeping with this norm, the powerful cattlemen tend to respond to grievances by using force and relying on their capital to keep the authorities from intervening in their unlawful activities, while ranchette owners are left without power to respond to trespassing by the cattlemen's animals. This combination results in a situation whereby cattle roam freely and cause damages that go uncompensated, while ranchette owners "choose" not to commence legal proceedings or even submit informal monetary claims, in an unreciprocated effort to maintain positive relations with the cattlemen.

To summarise, controller-selecting norms in Shasta County are embedded in local hierarchies. The powerful cattlemen use (sometimes violent) self-help measures, while the officials overlook such disputes. Ranchette owners, on the other hand, lack the social capital to succeed in the execution of private justice. As a result, they either seek the assistance of public officials (who usually turn them down), thereby running the risk of violating local norms of neighborliness, or absorb their grievances toward cattlemen and "choose" to get along.

¹¹³ Ibid at 43.

Another weakness of Ellickson's research is the failure to appreciate the fact that private ordering generally takes place under the aegis of the public order, which controls its implementation and sets its boundaries. In Shasta County, the legal regime of open range, to a large extent, produced 'the neighbourly order of... absorbing the damage from trespass incidents.'¹¹⁴ In 1945, a Californian statute devolved the power to create local norms by authorising the Shasta County Board of Supervisors, which is a locally elected governing body, to "close the range" in sub-areas of the county.¹¹⁵ In doing so, the state transferred rule making to local elective institutions, thereby determining that a crucial norm would be shaped by the local power structure. The role of local hierarchies in the creation of norms by the board is apparent in two cases presented by Ellickson, although he incorrectly frames these cases as anomalies, when in fact they are better viewed as a form of regulatory capture by the ruling elites of Shasta County. The first case in 1973 involved three traditionalist cattlemen who let their cattle roam freely and ignored their neighbour's complaints about the resulting damages. Out of frustration, a petition was filed to close the particular range, and this was sent to John Caton, a newly elected board member and ranchette owner himself. At the hearing, two of the three cattlemen did not attend, while even the more active Shasta County Cattlemen's Association did not send a representative that, collectively, had the symbolic effect of dismissing the hearing as inconsequential. In fact, to reinforce their norm of private ordering, they ignored the hearing altogether and used informal sanctions, which were much more effective and enduring: after Caton and the other board members voted in favour of the closure, 'to chide him for supporting what they regarded as a lamentable precedent, [the cattlemen] referred to the affected area as "Catton's Folly". Caton got the point. During the next decade, he successfully persuaded the Shasta County Board of Supervisors to reject all

¹¹⁴ Yngvesson, above n 108 at 1797. See also, Ellickson, above n 6 at 54.

¹¹⁵ Ellickson, above n 6 at 3.

petitions that would have closed additional territories... of his district.’¹¹⁶

A further example of this process appears in Ellickson’s account of a cattleman who had experienced many years earlier recurring problems with a trespassing bull. This cattleman told a law enforcement official that he wanted to neuter the bull as an act of punishment, and the official replied that he would overlook the act if it did occur. The cattleman asserted that he then carried out his threat.¹¹⁷ In this case, the law enforcement official produced a space of non-intervention that enabled the emergence of private ordering. By contrast, the lower-ranked ranchette owners are generally informed, in a variety of ways, that their claims will not be addressed by the public order, and this leaves them with no option but to submit to intragroup hierarchies. Traditionalist cattlemen, who aspire to maintain an open range regime in Shasta County, have a powerful lobby that connects them to county officials. Despite the range of remedies offered by the formal legal system, the latter dissuade the victims of cattle trespass from submitting claims and, instead, inform them of the cattlemen’s open range rights. By electing to inform the ranchette owners of these particular rights, rather than the ranchette owner’s legal right to seize the trespassing animals, to obtain an injunction against the cattle owner in certain cases, and/or to receive compensation, the county officials intentionally direct ranchette owners away from the formal legal system, thereby contributing to the creation and perpetuation of Shasta’s private ordering.

E. CONCLUSION

For several decades or more, the literature on company law has been dominated by a singular and rather myopic economic vision of that law and its institutions. In the pursuit to

¹¹⁶ Ibid at 32.

¹¹⁷ Ibid at 58.

understand the enterprise-specific interactions between corporate actors, this dominant disciplinary prism views the company, and the rules related thereto, merely as a nexus of explicit and implicit contracts. The logical implication is that company law rule making is essentially a variety of contract law, in which important corporate governance arrangements are the private outcome of a decentred, market-oriented process of negotiation, bargaining, and informational leverage between notionally rational participants that have an interest in the venture. This, in turn, is connected with the neo-classical economic optimism that there is a sort of pre-established harmony between the good of all and the pursuit by each of her own selfish economic gains. The upshot is that spontaneous governance can arise in a decentralised, emergent fashion even within large communities of participants. However, it is not simply the nuanced and private nature of corporate governance arrangements that is significant. Equally notable is the frequent interactions that take place between law and markets. Taking their lead from neoliberal rationalities, proponents of this politico-economic theory have argued that conventional regulatory approaches, which are rooted in the bureaucratic form of centralised state agencies and realised through the medium of formalistic law, are a largely external and regressive force to be resisted in the interests of efficient profit making. Clearly, there is valuable potential in this theoretical turn to situate the animating principles of company law within a broader conceptual framework that gives meaning and coherence to them. However, what this literature largely has lacked, to date, is an empirical structure that unites it with physical or concrete experience of how private systems of rules work to regulate socio-economic relations among the groups that adopt them. The present argument, then, identifies two functional falsities of the orthodox understanding of the company as a major site of private ordering established through contract. It provided these insights through a critical reflection on the wider private ordering literature, which has expanded exponentially over the last two decades.

There can be little doubt that much of this empirical evidence has generated interesting and important understandings into cases in which parties have established private legal systems for governing their behaviour and resolving their disputes. Yet a closer reading of two pioneering and representative ethnographic studies provides a different narrative, and is one that offers valuable direct insights for economic and economically influenced company law scholarship. The first insight is that corporate private ordering is created not necessarily because private governance arrangements are efficient or more efficient than public lawmaking institutions, nor can they be viewed as choice-based, voluntary, and consensual mechanisms for achieving socio-economic order that is better aligned with individual liberty and autonomy than the coercive legal system. The critical analysis of actual private orders in this article points, instead, to the conclusion that such structures typically develop in an existing context of hierarchical power relations whereby the more dominant members of that network are intent on deepening and entrenching a system of order. This tiered structure is clearly reflected in a general trend in company and securities law since the 1970s towards the increasing dominance of capital (above social or public concerns) and an associated political project to orientate equity holders at the centre of the corporate governance process. Second, it has been argued that the insights from the empirical analysis of this article show that the theoretical economic inquiry into endogenously generated rules obscures the interaction between law and markets. It is important to understand that private ordering or other regulators of corporate behaviour do not inevitably come from self-enforcing natural law. More precisely, many non-legal norms and rules, if they are to operate at all, arise and persist because of intentional dynamic strategies employed by the regulatory state and its organs to facilitate and influence the utility and nature of private orders.¹¹⁸ These understandings serve

¹¹⁸ Campbell, above n 64 at 326, opining that, ‘no market... can conform to the assumption of fully contingent

to further call into question the inherent shareholder exclusivity of modern UK company law, and also the idealised capabilities of spontaneous governance that are expressed in law and economics literature. It is therefore time to re-orientate and correct the explanatory lens through which to think about, write about, and teach what a company is and why it exists.

contracting, nor exist free of regulation'. See also, R. L. Hale, 'Coercion and Distribution in a Supposedly Non-Coercive State' (1923) 38(3) *Political Science Quarterly* 470.